

January 25, 2002

MEMORANDUM FOR: INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR PREFILING AND TECHNICAL GUIDANCE

FROM: Thomas W. Wilson, Jr. /s/ Thomas W. Wilson, Jr.
Industry Director, Communications, Technology, and Media

SUBJECT: Industry Directive on Stock Options and Cost Sharing Agreements

Recent developments require a change in use of resources on the issue of including compensatory stock options in the costs shared under section 482 qualified cost sharing arrangements.

For open tax years subject to the § 482 cost sharing regulation in effect prior to the effective date of Treas. Reg. § 1.482-7, *i.e.*, tax years beginning prior to January 1, 1996, we will no longer make adjustments to the cost pool with respect to stock-option compensation. Any pending audits of this issue for these years should be discontinued.

The current regulation under Treas. Reg. § 1.482-7 provides that all intangible development costs, as defined, must be included in the cost base of a qualified cost sharing arrangement. Therefore, for open tax years that are subject to Treas. Reg. § 1.482-7, *i.e.*, tax years beginning after December 31, 1995, we will require sharing of stock-option compensation costs attributable to the development of the intangibles under a qualified cost sharing arrangement. Such costs will be treated as operating expenses, under Treas. Reg. § 1.482-7(d)(1), that must be included in the pool of costs to be shared by the participants in the arrangement so as to make a participant's share of the costs equal to its share of reasonably anticipated benefits attributable to the development of the intangible under the arrangement, under Treas. Reg. § 1.482-7(a)(2). Adjustments to effect the sharing of such costs will be made as follows:

1. In cases where the taxpayer's return under audit does not include stock-option compensation costs in the cost pool, an adjustment will be made. Compensatory stock options for purposes of the adjustment will be valued by reference to the difference between the value of the exercise price and the fair market value of the underlying stock as of the date such options are exercised.
2. Where the taxpayer's return under audit or position on audit includes stock-option compensation costs in the cost pool, the taxpayer's method of determining the amount of costs to be shared will be accepted if the taxpayer shows that such method is reasonable and is applied reasonably and consistently. If, on the other hand, the method used by the taxpayer is unreasonable or is not reasonably and consistently applied, an adjustment will be made based on the "spread" at date of exercise, described in the preceding paragraph. The determination of reasonableness must be coordinated with the Associate Chief Counsel (International).

I believe this should clarify our approach for the future and allocate resources to those issues that will be more sustainable in post-audit processes.

This LMSB Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.